

Contents

Preface	x	Benchmark Spread	93
1 Introduction	1	Term Structure of Interest Rates	99
<i>Learning Objectives</i>	1	Swap Rate Yield Curve	119
<i>Sectors of the U.S. Bond Market</i>	2	Key Points 120 Questions 122	
<i>Overview of Bond Features</i>	3	6 Treasury and Federal Agency Securities	125
<i>Risks Associated with Investing in Bonds</i>	8	<i>Learning Objectives</i>	125
<i>Overview of the Book</i>	11	<i>Treasury Securities</i>	125
<i>Questions 12</i>		<i>Stripped Treasury Securities</i>	133
2 Pricing of Bonds	14	<i>Federal Agency Securities</i>	134
<i>Learning Objectives</i>	14	<i>Key Points 137 Questions 138</i>	
<i>Review of Time Value of Money</i>	14	7 Corporate Debt Instruments	140
<i>Pricing a Bond</i>	20	<i>Learning Objectives</i>	140
<i>Complications</i>	26	<i>Seniority of Debt in a Corporation's</i>	
<i>Pricing Floating-Rate and</i>		<i>Capital Structure</i>	141
<i>Inverse-Floating-Rate Securities</i>	28	<i>Bankruptcy and Creditor Rights</i>	142
<i>Price Quotes and Accrued Interest</i>	30	<i>Corporate Debt Ratings</i>	144
<i>Key Points 31 Questions 32</i>		<i>Corporate Bonds</i>	146
3 Measuring Yield	34	<i>Medium-Term Notes</i>	153
<i>Learning Objectives</i>	34	<i>Commercial Paper</i>	156
<i>Computing the Yield or Internal Rate</i>		<i>Bank Loans</i>	158
<i>of Return on any Investment</i>	35	<i>Default Risk for Corporate Debt Instruments</i>	163
<i>Conventional Yield Measures</i>	38	<i>Corporate Downgrade Risk</i>	166
<i>Potential Sources of a Bond's Dollar Return</i>	46	<i>Corporate Credit Spread Risk</i>	167
<i>Total Return</i>	49	<i>Key Points 168 Questions 169</i>	
<i>Applications of the Total Return</i>		8 Municipal Securities	172
<i>(Horizon Analysis)</i>	54	<i>Learning Objectives</i>	172
<i>Calculating Yield Changes</i>	54	<i>Types and Features of Municipal Securities</i>	173
<i>Key Points 55 Questions 55</i>		<i>Municipal Money Market Products</i>	178
4 Bond Price Volatility	58	<i>Floaters/Inverse Floaters</i>	179
<i>Learning Objectives</i>	58	<i>Credit Risk</i>	180
<i>Review of the Price-Yield Relationship</i>		<i>Risks Associated with Investing</i>	
<i>for Option-Free Bonds</i>	59	<i>in Municipal Securities</i>	182
<i>Price-Volatility Characteristics</i>		<i>Yields on Municipal Bonds</i>	183
<i>of Option-Free Bonds</i>	60	<i>Municipal Bond Market</i>	184
<i>Measures of Bond Price Volatility</i>	62	<i>The Taxable Municipal Bond Market</i>	186
<i>Convexity</i>	73	<i>Key Points 186 Questions 187</i>	
<i>Additional Concerns When Using Duration</i>	82	9 International Bonds	189
<i>Do Not Think of Duration as a Measure of Time</i>	82	<i>Learning Objectives</i>	189
<i>Approximating a Bond's Duration and</i>		<i>Classification of Global Bond Markets</i>	190
<i>Convexity Measure</i>	83	<i>Non-U.S. Bond Issuers and Bond Structures</i>	191
<i>Measuring a Bond Portfolio's Responsiveness</i>		<i>Foreign Exchange Risk and Bond Returns</i>	193
<i>to Nonparallel Changes in Interest Rates</i>	85	<i>Bonds Issued by Non-U.S. Entities</i>	194
<i>Key Points 89 Questions 90</i>		<i>Key Points 206 Questions 207</i>	
5 Factors Affecting Bond Yields and the Term		10 Residential Mortgage Loans	209
Structure of Interest Rates	92	<i>Learning Objectives</i>	209
<i>Learning Objectives</i>	92	<i>Origination of Residential Mortgage Loans</i>	210
<i>Base Interest Rate</i>	93	<i>Types of Residential Mortgage Loans</i>	211

<i>Conforming Loans</i>	219	<i>Collateralized Debt Obligations</i>	335
<i>Risks Associated with Investing in Mortgage Loans</i>	220	<i>Key Points 337 Questions 338</i>	
<i>Key Points 221 Questions 221</i>		16 Pooled Investment Vehicles for Fixed-Income Investors	340
11 Agency Mortgage Pass-Through Securities	223	<i>Learning Objectives</i>	340
<i>Learning Objectives</i>	223	<i>Investing in Pooled Investment Vehicles</i>	341
<i>Sectors of the Residential Mortgage-Backed Security Market</i>	224	<i>Investment Company Shares</i>	342
<i>General Description of an Agency Mortgage Pass-Through Security</i>	225	<i>Exchange-Traded Funds</i>	346
<i>Issuers of Agency Pass-Through Securities</i>	227	<i>Hedge Funds</i>	352
<i>Prepayment Conventions and Cash Flow Factors Affecting Prepayments and Prepayment Modeling</i>	228	<i>Real Estate Investment Mortgage Trusts</i>	354
<i>Cash Flow Yield</i>	235	<i>Key Points 356 Questions 357</i>	
<i>Prepayment Risk and Asset/Liability Management</i>	240	17 Interest-Rate Models	358
<i>Secondary Market Trading</i>	242	<i>Learning Objectives</i>	358
<i>Key Points 244 Questions 245</i>	243	<i>Mathematical Description of One-Factor Interest-Rate Models</i>	359
12 Agency Collateralized Mortgage Obligations and Stripped Mortgage-Backed Securities	248	<i>Arbitrage-Free versus Equilibrium Models</i>	362
<i>Learning Objectives</i>	248	<i>Empirical Evidence on Interest-Rate Changes</i>	364
<i>Agency Collateralized Mortgage Obligations</i>	249	<i>Selecting an Interest-Rate Model</i>	366
<i>Agency Stripped Mortgage-Backed Securities</i>	282	<i>Estimating Interest-Rate Volatility Using Historical Data</i>	367
<i>Key Points 284 Questions 285</i>		<i>Key Points 370 Questions 371</i>	
13 Nonagency Residential Mortgage-Backed Securities	288	18 Analysis of Bonds with Embedded Options	372
<i>Learning Objectives</i>	288	<i>Learning Objectives</i>	372
<i>Collateral Types</i>	290	<i>Drawbacks of Traditional Yield Spread Analysis</i>	373
<i>Credit Enhancement</i>	290	<i>Static Spread: An Alternative to Yield Spread</i>	373
<i>Cash Flow for Nonagency Mortgage-Backed Securities</i>	296	<i>Callable Bonds and their Investment Characteristics</i>	378
<i>Key Points 301 Questions 302</i>		<i>Components of a Bond with an Embedded Option</i>	380
14 Commercial Mortgage Loans and Commercial Mortgage-Backed Securities	304	<i>Valuation Model</i>	382
<i>Learning Objectives</i>	304	<i>Option-Adjusted Spread</i>	395
<i>Commercial Mortgage Loans</i>	305	<i>Effective Duration and Convexity</i>	395
<i>Commercial Mortgage-Backed Securities</i>	307	<i>Key Points 397 Questions 398</i>	
<i>Types of Deals</i>	312	19 Analysis of Residential Mortgage-Backed Securities	400
<i>Key Points 314 Questions 315</i>		<i>Learning Objectives</i>	400
15 Asset-Backed Securities	317	<i>Static Cash Flow Yield Methodology</i>	401
<i>Learning Objectives</i>	317	<i>Monte Carlo Simulation Methodology</i>	409
<i>Creation of an Asset-Backed Security</i>	318	<i>Total Return Analysis</i>	423
<i>Collateral Type and Securitization Structure</i>	323	<i>Key Points 424 Questions 425</i>	
<i>Credit Risks Associated with Investing in Asset-Backed Securities</i>	324	20 Analysis of Convertible Bonds	428
<i>Review of Several Major Types of Asset-Backed Securities</i>	327	<i>Learning Objectives</i>	428
<i>Dodd-Frank Wall Street Reform and Consumer Protection Act</i>	334	<i>Convertible Bond Provisions</i>	429
		<i>Categorization of Convertible Securities</i>	430
		<i>Basic Analytics and Concepts for Convertible Bond Analysis</i>	432
		<i>Option Measures</i>	436
		<i>Profile of a Convertible Bond</i>	438
		<i>Pros and Cons of Investing in a Convertible Bond</i>	438
		<i>Convertible Bond Arbitrage</i>	440

	<i>Options Approach to Valuation</i>	442			
	<i>Key Points 443 Questions 444</i>				
21	Measuring Credit Spread Exposures of Corporate Bonds	446			
	<i>Learning Objectives</i>	446			
	<i>Measuring Changes in Credit Spreads</i>	447			
	<i>Measuring Credit Spread Sensitivity</i>	447			
	<i>Empirical Duration for Corporate Bonds</i>	451			
	<i>Key Points 458 Questions 459</i>				
22	Corporate Bond Credit Analysis	462			
	<i>Learning Objectives</i>	462			
	<i>Overview of Corporate Bond Credit Analysis</i>	463			
	<i>Analysis of Business Risk</i>	464			
	<i>Corporate Governance Risk</i>	466			
	<i>Financial Risk</i>	468			
	<i>The Investment Decision</i>	471			
	<i>Corporate Bond Credit Analysis and Equity Analysis</i>	472			
	<i>Case Study: Credit Analysis of Sirius XM Holdings Inc.</i>	472			
	<i>Case Study: Sino-Forest Corporation</i>	482			
	<i>Key Points 488 Questions 488</i>				
23	Credit Risk Modeling	490			
	<i>Learning Objectives</i>	490			
	<i>Difficulties in Credit Risk Modeling</i>	491			
	<i>Overview of Credit Risk Modeling</i>	492			
	<i>Credit Ratings versus Credit Risk Models</i>	493			
	<i>Structural Models</i>	493			
	<i>Estimating Portfolio Credit Risk: Default Correlation and Copulas</i>	498			
	<i>Reduced-Form Models</i>	499			
	<i>Empirical Evidence: Credit Ratings, Structural Models, and Reduced-Form Models</i>	502			
	<i>An Application of Credit Risk Modeling</i>	503			
	<i>Incomplete-Information Models</i>	507			
	<i>Key Points 508 Questions 509</i>				
24	Bond Portfolio Management Strategies	510			
	<i>Learning Objectives</i>	510			
	<i>The Asset Allocation Decision</i>	511			
	<i>Portfolio Management Team</i>	512			
	<i>Spectrum of Bond Portfolio Strategies</i>	513			
	<i>Bond Benchmarks</i>	515			
	<i>The Primary Risk Factors</i>	521			
	<i>Top-Down versus Bottom-Up Portfolio Construction and Management</i>	522			
	<i>Active Portfolio Strategies</i>	523			
	<i>Smart Beta Bond Strategies</i>	537			
	<i>The Use of Leverage</i>	539			
	<i>Key Points 545 Questions 546</i>				
25	Bond Portfolio Construction				550
	<i>Learning Objectives</i>				550
	<i>Brief Review of Portfolio Theory and Risk Decomposition</i>				551
	<i>Application of Portfolio Theory to Bond Portfolio Construction</i>				552
	<i>Tracking Error</i>				554
	<i>Cell-Based Approach to Bond Portfolio Construction</i>				558
	<i>Portfolio Construction with Multi-Factor Models</i>				560
	<i>Key Points 575 Questions 575</i>				
26	Considerations in Corporate Bond Portfolio Management				580
	<i>Learning Objectives</i>				580
	<i>Risk-Return for Corporate Bonds versus Equities</i>				581
	<i>Corporate Bond Benchmarks</i>				583
	<i>Credit Relative Value Strategies</i>				588
	<i>Constraint-Tolerant Investing</i>				592
	<i>Using Credit Risk Modeling to Construct Corporate Bond Portfolios</i>				595
	<i>Liquidity Management for Corporate Bond Portfolios</i>				598
	<i>Key Points 604 Questions 605</i>				
27	Liability-Driven Investing for Defined Benefit Pension Plans				607
	<i>Learning Objectives</i>				607
	<i>Historical Background</i>				608
	<i>Understanding the Liabilities of DB Pension Plan Liabilities</i>				608
	<i>LDI Strategies</i>				611
	<i>De-Risking Solutions to Mitigate Risk</i>				614
	<i>Strategies for Hedging Interest-Rate Risk</i>				615
	<i>Key Points 623 Questions 624</i>				
28	Bond Performance Measurement and Evaluation				626
	<i>Learning Objectives</i>				626
	<i>Requirements for a Bond Performance and Attribution Analysis Process</i>				627
	<i>Performance Measurement</i>				627
	<i>Performance Attribution Analysis</i>				633
	<i>Key Points 638 Questions 639</i>				
29	Interest-Rate Futures Contracts				641
	<i>Learning Objectives</i>				641
	<i>Mechanics of Futures Trading</i>				642
	<i>Futures versus Forward Contracts</i>				644
	<i>Risk and Return Characteristics of Futures Contracts</i>				644

<i>Interest-Rate Futures Contracts</i>	645	<i>Hedge Strategies</i>	712
<i>Pricing and Arbitrage in the Interest-Rate Futures Market</i>	651	<i>Key Points 718 Questions 719</i>	
<i>Bond Portfolio Management Applications</i>	658	31 Interest-Rate Swaps, Caps, and Floors	721
<i>Key Points 676 Questions 677</i>		<i>Learning Objectives</i>	721
30 Interest-Rate Options	679	<i>Interest-Rate Swaps</i>	722
<i>Learning Objectives</i>	679	<i>Interest-Rate Caps and Floors</i>	744
<i>Options Defined</i>	680	<i>Key Points 750 Questions 751</i>	
<i>Differences Between an Option and a Futures Contract</i>	680	32 Credit Default Swaps	754
<i>Types of Interest-Rate Options</i>	680	<i>Learning Objectives</i>	754
<i>Intrinsic Value and Time Value of an Option</i>	683	<i>Credit Events</i>	755
<i>Profit and Loss Profiles for Simple Naked Option Strategies</i>	684	<i>Single-Name CDS</i>	758
<i>Put-Call Parity Relationship and Equivalent Positions</i>	696	<i>Index CDS</i>	764
<i>Option Price</i>	698	<i>Economic Interpretation of a CDS and an Index CDS</i>	766
<i>Models for Pricing Options</i>	699	<i>Using CDSs for Controlling Credit Risk</i>	768
<i>Sensitivity of Option Price to Change in Factors</i>	708	<i>Key Points 769 Questions 770</i>	
		Index	773